215. During periods where enhanced credits were awarded, FAs could earn as much as 8 times that amount (or 100 bps) for sales of ARS. Other enhanced payouts could include payouts of 25 bps, or 50 bps. Similar to regular production credits earned, FAs enhanced production credits would be applied to the grid resulting in FAs being paid a certain pre-determined percentage of the enhanced production credit.

216. Enhanced production credits reportedly would apply only to the initial auction period and would automatically reset to the default 12.5 bps at the next auction cycle.

217. The use of enhanced production credits as a means of motivating FAs to sell ARS was not universally accepted at Merrill Lynch. A September 27, 2007 email from Constable to Price included a discussion surrounding the practice and highlighted Merrill Lynch's internal debate over whether such incentives should have been used. Constable expressed the importance of using ARS inventory to Price:

> We are of course being criticized for our 25, 50 and 100 bp extra pcs. Stu Wexler came around with the text of an email that he wants to send out to all Fas which I am convinced would be our **death knell** if it goes out. We need to sit down before anything else is sent and determine what part of our market is bullet proof and beyond the scope of any type of failure, which should be the bulk of what we trade and decide if it is so unsuitable for us to use sales credits as incentives. I am near the end of my rope on this line of thinking.

(See Exhibit 39) (Emphasis added)

218. On November 21, 2007, Mitch Cox, of Merrill Lynch's Financial Products Group, sent an email to Price, among others, and instructed, in part, "[w]hile GMI has offered to increase PCs on VRP production, I do not think that such an increase will be necessary (or advisable) at this time." Cox offered to revisit the issue in the new year "when our forecast is more conducive to a broader floating rate marketing initiative." (See Exhibit 31)

219. Price forwarded the Cox email to Constable with the instructions to, "[p]lease take off the incremental PC's we have added until we get the go ahead to add them…" Constable replied,

> "We will offer 25 bp which is still incremental but in line with our significant growth in inventory today as a result of the double auctions due to Thanksgiving. Derek [Sin] will resend the email without any specific mention of additional PCs, although the 25 bp will be in the PC column."

(See Exhibit 31)

220. In her testimony before the Division, Constable testified that no final decision was made as to whether enhanced production credits should be discontinued and that the practice continued production credits were "adjusted as we saw fit."

221. Constable's conclusion was that offering of enhanced production credits for sales of ARS was a valuable tool in motivating sales because it kept FAs focused on the product.

3. <u>Coordination with Research</u>

a. Proactive Involvement From The Supposedly Independent Research Department To Aid In Sales Efforts.

222. Merrill Lynch's Research Department played a pivotal role in assisting sales of Auction Rate Securities.

223. On at least two occasions during the Fall of 2007, Sales and Trading and the Auction Desk made direct and specific requests for the Research Department to draft favorable research pieces regarding the auction market to assist in Sales.

224. On August 14, 2007, William Kubeck, a Manager in the Financial Products Group made a request to Fran Faulkner in Research, for some research to be written to assist in a sales effort. Kubeck noted:

> Calls are helpful, however, attendance is usually not great. **Something published instead of or in addition to a call**

> **would have a better impact.** Perhaps this could be released as a special edition Fixed Income Digest report outlining current events as they relate to this market and what FAs should be telling clients.

(See Exhibit 32) (Emphasis added)

225. On August 20, 2007, Auction Desk employee, Robert Tomeny, made a direct request via email to Conery for research regarding certain auction rate securities that had auction failures. He asked Conery, "[a]ny chance you guys can update that old Centaur research piece Bess and Stuart Rosmiller published to include the auction rate series." Tomeny wanted to have something he "could send out to auction investors that describe[d] the structure in its entirety."

226. On November 30, 2007, Constable emailed Mauro in Research and updated him as to the lack of confidence existing in the auction market and then directly requested and suggested a positive research piece she wanted published. The communication stated:

> As you know, rates across our market have been backing up, due to a combination of a **renewed crumbling of confidence on the part of investors** as they absorb the recent spate of bad headlines about monoline insurerers (sic), bank and dealer exposure to subprime and their hits to earnings and a general lack of understanding of all our short term cash management alternatives. In the old "flight to T-Bills", the recurring conversation here on the AMS desk is a line out of "Marathon Man"—"Is it safe?". **Any renewed research focusing on the high quality of closed end fund preferreds of ALL tax status, auction municipal bonds and student loan backed bonds, wrapped around the value added proposition with today's rates would be extremely helpful.**
>
> I have already responded back to Tom Murray, agreeing to participate in another national sales call sponsored by Chris Dupuy. It cant come soon enough!! If you want to talk through any of the data, please let me know.

(See Exhibit 33) (Emphasis added)

227. On other occasions, Auction Desk personnel likely had prior notice that research was being drafted regarding the auction market before its publication was announced.

228. For instance, on the morning of August 9, 2007, Constable emailed Conery with a simple one line message which stated: "Research today?" (See Exhibit 34)

229. Later that evening, shortly after 7:30 pm, after apparently not receiving any response, Constable followed up with another e-mail to Conery which contained four full lines of question marks. (See Exhibit 35)

230. In her testimony before the Division, Constable could not recall the "context" of the two emails, but confirmed that she and the Auction Desk should only be informed that a research piece is being published until after it was published.

231. On August 10, 2007, Conery and the Research Department published a significant piece related to the Auction Market entitled: "Turmoil and Opportunity in Auction Market." The report explained recent auction failures and took great care in distinguishing "144A" or private placement auction failures involving qualified institutional buyers, from individual investors who were, "relatively unharmed as they have been largely active in the more conservative and public sectors."

232. Conery's focus was to distinguish the recent failures and emphasize that those failures were "likely to be fairly contained within...CLO/CDO issues and certain issues guaranteed by non-Aaa/AAA rated financial guarantors." In the end, Conery took the opportunity to endorse purchases of ARS when he opined: "We believe there could be many opportunities to take advantage of relative value situations without taking on undue or excessive amounts of credit or liquidity risk."

233. In the days and weeks that followed, Constable and/or other members of the Auction Desk provided Conery's August 10th Report to FAs and customers seeking clarity of recent events in the auction market.

b. Improper Information Sharing –Between Research and Sales and Trading.

234. The Division's investigation revealed that Conery had frequent communications with John Price, Merrill Lynch's Head of Americas Credit and Trading at Merrill Lynch, and the direct supervisor of Constable and her ARS Auction Desk.

235. Merrill Lynch Policy & Procedures Manual (the "Policies Manual") employs a so-called "Chinese Wall," which is designed to prevent "the misuse of material non-public information" and to prevent "even the appearance of impropriety."

236. The "Chinese Wall" is designed to "restrict and monitor the flow of information between the various areas of [Merrill Lynch] such as Global Research, Sales [and] Trading," among others "to avoid the misuse of such information and the appearance of impropriety as well as to manage potential conflicts of interest…"

237. Among those departments that constitute the "Private Side of the Wall" include: "Investment Banking, including Global Capital Markets and Financing (Equity Capital Markets and Debt Capital Markets)," and "other departments or individuals that regularly receive inside information," while the Research Division is on the "Public Side of the Wall."

238. "Confidential Information" is defined in the Policy as "[n]on-public information that is received or created by Merrill Lynch in the course of its business activities."

239. "Material Information" is defined in the Policies and Procedures as that information in which "there is a substantial likelihood that a reasonable investor would consider the information important in deciding whether or not to purchase, hold, or sell a security or other financial instrument," and includes "liquidity problems, defaults or other credit-related problems or events" and "increases or declines in orders for the company's securities."

240. "Proprietary Information" is defined as "[n]on public information of whatever type that is created or obtained by Merrill Lynch for the firm's business purposes." Examples of Proprietary Information include, "unpublished research information, opinions, and recommendations" and "non-public information about Merrill Lynch's securities trading positions and securities products," "Merrill Lynch's intentions regarding its proprietary accounts, investment, trading, lending activities or financial strategies or decisions."

241. Among the categories of information that cannot be discussed between Sales or Trading and Research are the levels or amounts of inventory that Merrill Lynch maintained for its own account.

242. During its investigation, the Division interviewed Conery and reviewed his work notebooks (the "Notebooks"), which he maintained as part of his business records. The Notebooks were maintained in chronological order and recorded information such as telephone calls and subject matter discussed.

243. In their testimony before the Division, both Price and Conery confirmed that the two communicated with each other directly from time to time, sometimes by telephone. The Notebook contained a significant number of references to "J.P.," which the Division understands to mean John Price.

244. On July 24, 2007, Conery was informed of and noted "[h]eavy supply, low liquidity + wide spreads" relative to the auction market and acknowledged "current volatility... Supply – shifting story – pent up issuer [illegible]...-Biggest shift to $25 par market..." Conery also noted that new issues for 2007 were "historically high."

245. On August 7, 2007, in a discussion with Price, Conery noted in his journal that "liquidity providers" were "looking for out." Further, Conery took note of "several failed auction[s]..."

246. On October 2, 2007, just one week after hearing from Constable that the auction desk had reached its inventory ceiling of $1 billion dollars, Price notified Conery that inventory reached "$1 billion last week" and that "Finance[s] are challenged..."

247. On November 20, 2007, just one day after Price and the Auction Desk received its inventory reduction instructions from Scott Brown and the Fixed Income Currency and Commodities Group, Conery recorded a discussion with Price in the Notebook that reflects a detailed discussion regarding the specific breakdown of Merrill Lynch's ARS inventory position and the plan to reduce. The entry provided:

> JP – year end...-liquidity – Bal sheet – issues early...-
> Auction market preferred...-prefer + private placement...$
> Tax...$816 tax-exempt...90 taxable muni...$101 – tax
> exempt prefer...total $ 2.318 Billion

248. The same day, on November 20, 2007, Conery's Notebook reflected a notation that he learned of Merrill Lynch providing sales incentives to FAs in the form of enhanced production credits.

249. Later on the same day, Conery's Notebook reflects a follow up discussion with Price in which he notes considerable difficulties with interest spreads and liquidity in the auction markets. Specifically, the entry provided: "JP – Wider this morning...-liquidity large problem."

250. On January 8, 2008, Conery received a briefing from Price regarding the status of the auction market: The notes provided, in part:

> JP: Front-end – unfreezing a bit...-some extendible getting
> done...-CP _ will be smaller size but clean...- Push –
> Retail CDs... DRD + Retail
>
> -Customer participation – Very little...- Could go wider...-
> View that Wall Street firm will have to have distressed
> underwriting at fire sale prices...-Desk – Short – across
> every desk...-Liquidity – Cash will trade at premium...-
> tighter balances...

251. Finally, throughout the time period of August 2007 to February 2008, Conery was also regularly provided copies of Merrill Lynch's daily sales listings, known as "axe sheets," which contained significant non-public information, including but not limited to, Merrill Lynch's inventory positions as well as the production credits that were available to FAs who were selling the product. By being informed on a daily basis of what was available for sale, Conery could compare the axe sheets to see trends in Merrill Lynch's inventory positions as well as the time periods in which so called enhanced sales credits were being applied to FA sales.

252. Conery also had frequent, unmonitored and unfettered access to all of Merrill Lynch's Auction Desk personnel, and frequently visited the Auction Desk without any supervision of information or conversations he was privy to.

F. Improper Influence And Pressure Over Supposedly Independent Research Personnel.

253. Merrill Lynch permitted its Sales and Trading and Auction Desk personnel to have undue influence over its Research Department regarding its coverage of the auction market.

254. In addition to the direct requests of Sales and Trading and the Auction Desk to Research for positive published material related to the auction market (noted in Section E (3)(a) above), undue influence was also exercised over the content of the published research reports.

255. In particular, in late August 2007, Constable objected to and demanded a retraction of one research piece, which she alleged "could single handedly undermine the Auction Market."

256. The research piece in question was written and published on August 21, 2007, by Mauro, a Fixed Income Strategist and Phil Fisher, a Municipal Strategist, in Merrill Lynch's Research Department. The piece, entitled, "Liquidity Features of Short-

Term Municipal Securities," was published in Merrill Lynch's Fixed Income Digest primarily for the purpose of highlighting the differences in liquidity features for auction rate preferreds and Variable Rate Demand Obligations ("VRDOs") and certain recent failed auctions. The primary distinction noted by Mauro was that VRDOs have a hard put – or a demand feature built in that "assures investors of being able to receive the par value plus accrued interest back at the reset date, barring some event that impairs the ability of the institution that provides the put to be able to make good on the agreement." Mauro then noted that Auction rate preferreds have no hard put and that holders of securities without hard puts need to rely on other buyers in the market to redeem the security at par." (See Exhibit 36)

257. Conery did not participate in or contribute to the drafting of Mauro's August 21st published report.

258. Upon reading Mauro's research report, Constable immediately called Mauro and demanded a retraction and clarification on the grounds that it was misleading to speak about failures in a municipal market research piece when the failures were limited to auction rate securities backed by CDO's and CLO's.

259. In her testimony before the Division, Constable acknowledged that while the information contained in the report was factually correct, she felt it was presented out of context since the title of the report referenced "Municipal securities" and that there were no auction failures up to that point were restricted to CLO/CDO issues.

260. Constable testified that she spoke with Mauro on the morning of August 22nd, and objected to the piece. Constable testified that Mauro refused to retract the report at that time on the grounds that it was accurate.

261. After failing to get Mauro to retract the report on her own, Constable next went to the Auction Desk and showed the piece to her boss, John Price.

262. Although Constable "felt strongly" enough about the piece to bring it to her boss' attention, in her testimony before the Division, Constable stated she could not

remember making any request for action to Price. In fact, Constable could not recall anything that was discussed with Price, other than she brought it to his attention. Price, in his testimony , denied knowledge of the conversation with Constable and even denied knowledge of the existence of the Mauro research piece.

263. Constable then called Conery and asked him to review the report. Later the same day, Constable wrote to Tina Singh and Tom Lee in Financial Products Group stating in all caps:

> I HAD NOT SEEN THIS PIECE UNTIL JUST NOW AND IT MAY **SINGLE HANDEDLY UNDERMINE THE AUCTION MARKET**. IF YOU ARE GETTING ANY CALLS, PLEASE LET ME KNOW. I HAVE ASKED FOR AN IMMEDIATE CLARIFICATION TO BE PUBLISHED AND A RETRACTION OF THIS.

(See Exhibit 37) (Emphasis added)

264. At some point in time during the day on August 22, 2007, the Research Department agreed to retract the report and issue a new or replacement report in its place. Email communications confirm that Conery made significant suggested changes that were adopted almost verbatim by Mauro.

265. The new report was published on August 23, 2007, but was dated August 22, 2007. While the report still contained similar information contained in Mauro's initial report regarding VRDOs having a hard put and ARS not having a hard put, the overall emphasis had changed and significant additions were added to the new piece. For instance, the cover page of the Report changed the focus of the piece from distinctions in liquidity between VRDOs and ARS to recommending that investors buy auction market securities, VRDOs and R-Floats. The new piece provided, in part,:

> Auction market securities, VRDOs, and R-FLOATS are alternatives to money market funds. **Yields on these**

securities have risen in recent weeks over what we believe are misplaced concerns. Although rates could remain volatile, we think these securities offer good value now.

(See Exhibit 38) (Enphasis Added)

266. Other distinctions between the two research pieces included the following:

- In the first paragraph of the revised piece, "**degree of liquidity**" was replaced with "**point out how liquidity is provided** in the major alternatives to money market funds."
- Second paragraph includes changes which reiterate a previous research piece's opinion that "the current rise in auction yields as a buying opportunity."
- An excerpt section in the margin notes: "Yields on auction market securities have risen to levels that **we find very attractive**."
- The new report included an added section on Closed End Funds: "Each auction program has a least one broker dealer associated with it. **The liquidity is enhanced by the broker dealer's market making activities. Typically, the broker acts in a principal capacity as it conducts its market support activities, although it is only contractually obligated to act as an agent."**
- The new report changed prior version's reference to "several failed auctions" to "some." In addition, a distinction is added that all failures involved private placement (144a issuers) with a bold sentence stating: "**None of the recent failed auctions involved securities held by individual investors**."

- The new report included an assurance that "the securities sold to individual investors have no direct exposure to [subprime mortgages CDOs/CLOs]."

(Compare Exhibits 37 & 38) (Emphasis added)

267. On August 23, 2007, after the re-written research piece was released, and the auctions were concluded for the day, Constable noted in and email to Price and others:

> ...Revised research from Marty Mauro promoting short term alternatives to money market funds and the liquidity features of auction and other municipal products in conjunction with Kevin Conery's research of last week **have been essential tools in our sales arsenal**.

(See Exhibit 39)(Emphasis added)

268. Mauro's experience with Constable, had lasting effects on Conery and others in the Research Department. In January 2008, after completing some suggested changes to a draft research report, Conery asked fellow Research Analyst, Jon Maier to have someone else review his suggested changes before publishing the report. Specifically, Conery stated:

> I'd really appreciate you showing this to Marty [Mauro] before hand. **I want to make sure that research cannot be accused of causing a run on the auction desk, like was the case in August. I think we have sufficiently covered that risk, but would like his thoughts**.

(See Exhibit 40) (Emphasis added)

269. Conery's comments illustrate perfectly the repressive conditions under which research reports that touched upon issues facing the Auction Market were crafted. Simply stated, objectivity had to be tempered and shaped to understate negative market events and known risks affecting ARS in order to minimize the potential adverse consequences to Merrill Lynch's marketing and sales of ARS.

270. Conery and Mauro also understood that their research reports would be scrutinized by the Auction Desk and they sought and relished the Desk's approval. On December 7, 2007, Conery emailed Mauro and another Research Department employee and noted the following: "FYI, I was at the IAD holiday party last night. Got some glowing comments on the auction market report from such people as Frances Constable and Doug Mellert..." (See Exhibit 41)

271. Conery had co-authored a Research piece published in the Fixed Income Digest Special Edition, with Mauro entitled, "Enduring Value in Auction Securities" which was released the day before on December 6, 2007. The piece featured recommendations endorsing ARS, while arguing the "Credit fears are largely misplaced in the auction market," and that "we remain convinced that auction market preferreds of closed-end funds are a conservatives' conservative security." (See Exhibit 42)

272. Other times, Auction Desk Personnel attempted to directly influence how Research responded to FA questions during sales calls. In one instance in August 2007, Conery was answering FA questions in a "Q&A" style sales call. Constable had also dialed in to the call and was listening in. After one question was asked, which apparently was not to Constable's liking, she emailed, or instant messaged Conery and stated: "**Shut this guy down. Suggest he call outside this call. He is focusing attention away from your positive message**." (See Exhibit 43) (Emphasis added)

273. Conery himself, viewed his position as a Research Analyst in large part as being a source to assist Merrill Lynch's Auction Desk's business of selling ARS. On December 12, 2007, he responded to an email from his supervisor in the Research Department, Mary Rooney, who was seeking input for Conery's year-end review. Conery highlighted his service to the Auction Desk by stating,, in part: "auction market – integral and well coordinated with the auction desk...A large number of conference[s] helped to significantly improve liquidity and lower inventory levels."

274. In her official Performance Review Form of Conery, which was signed by both Rooney and Conery , Rooney incorporated Conery's suggestions.

275. The Performance Review evaluated Conery for competency in four key areas: Strategic Thinking; Business Results; People Leadership and Personal Effectiveness. With regard to Conery's performance toward the "Business Results" of the firm, Rooney noted:

> Kevin has a strong **partnership with the Auction Rate Preferred business**. This market was under extreme stress this year due to the credit/liquidity crunch. Kevin worked closely with **his business partners** to communicate key issues facing a rather opaque market place. **Here he engaged in proactive and timely interchange with sales, and corporate cash clients, and GPC. Ultimately, his work contributed to better liquidity and lower inventory levels in the marketplace**. (Emphasis added)

276. In the wake of his performance review at year end, Conery was awarded a significant six-figure bonus for his job performance in 2007.

277. The Performance Review also included a "Cross Comments" Section which described Conery's "Strengths" and "Development Needs" as described by co-workers. Significantly, the Review Committee for Conery included members of the Auction Desk including Constable and her supervisor, Price.

278. One developmental need expressed by an evaluator was: "Feel Kevin can be too connected to the trading desks/should be allowed to be more independent. I don't see this as a Kevin issue but rather a desk issue and the pressure they exert for his support."

279. Conery's close relationship and loyalty to the Auction Desk was illustrated in one email exchange with Auction Desk trader, Derek Sin in early December 2007. Sin originally forwarded a recent Merrill published research piece that was "worth a read" and attributed the publication to Martin Mauro and "other ML Research analysts."

Conery mockingly protested the snub of not being specifically mentioned as being a contributor to the publication noting that the last time Mauro wrote anything on his own: "can you say run on the auction market? And that was when he thought he was endorsing auction securities." Sin responded, in part, "Don't worry, we know who our friends are..." to which Connery responded: "You better."

280. By assisting the Auction Desk with research, sales calls and client conversations, Constable clearly viewed Conery as being part of "the team." One instance that best illustrates that point occurred on January 28, 2008, shortly before the Auction Market imploded. An Institutional Advisory Division representative in California sent Constable a very glowing endorsement of Conery in the wake of Conery's time spent in a conference call with the representative's corporate clients. Conery had spent quite a bit of time explaining various auction products to the company's Treasurer and "handled the client's difficult questions" concerning the auction market. The representative ended her note with the following: "Our clients now feel they have a much better understanding of the issues, and are reassured about their investments in muni Closed End Funds." Constable forwarded the email to, among others, Conery's boss in the Research Department and her own boss, John Price noting, in part: "Kevin has always held himself out in a climate-agnostic capacity. It is great to have him on the team..." (See Exhibit 44)

281. Rooney then forwarded the email chain to Conery and informed him: "Kevin – Excellent feedback from the Auction Rate Desk. Many of the investors in the product are important corporate clients to our firm. Nice Work! Rgds, Mary." (Id.)

282. Despite the confidence Conery apparently instilled in the client, less than three weeks later, Merrill Lynch would intentionally allow most of its auctions to fail leaving thousands of investors with illiquid investments.

283. In a Form 10-Q Quarterly Report, filed with the Securities and Exchange Commission, a company with the same name as the one referenced in the email reported

holding over $110 million in illiquid ARS and recorded a temporary impairment charge of over $5 Million.

G. Events Leading To Merrill Lynch's Decision To Stop Broadly Supporting Its Auction Program.

284. Concerns surrounding the auction market grew more ominous going into the new year and Merrill Lynch's Auction Desk personnel began to brace for the worst. For instance, on January 9, 2008, Auction Desk Senior Trader, Jim Brewer, emailed Edward Curland (GMI NYMUNI) a list of ARS issues that were insured by insurance companies that were at risk for downgrade by the rating agencies and those issues' dim prospects of successfully clearing in upcoming auctions should the downgrades occur. Brewer advised:

> Ed-
> The attached file contains the lead managed XL & FGIC Insured issues we currently trade on the auction desk. It seems increasingly likely that these two monocline insurers are going to be downgraded. **We anticipate that if that happens there will be a wave of selling in these issues that we will be unable to support causing the auctions to fail. If any of these issues fail one can make the assumption that it will spread to the other sectors of our market regardless of the insurer or ratings**. Is anyone proactively working on a contingency plan in the event that these issues are downgraded?

(See Exhibit 45) (Emphasis added)

285. Two days later, Constable emailed her colleagues on the Auction Desk with a copy of an internal Risk Management document in which the firm was analyzing options to reduce risks associated with certain auction market preferred inventory. One , page of the analysis, which was marked "For Internal Use Only" and "Confidential – Not For Distribution" dealt with Merrill Lynch's so called "risky preferred" auction market preferred stock and provided in part:

> OPTIONS TO REDUCE RISK
> ...Option #3: Fail future auctions

> Pros: ML balance sheet will be capped at levels today.
> Cons: ML cannot fail our own paper and may be forced to take that back.
>
> (See Exhibit 46)

286. On the same date, Price replied to a Risk Manager with respect to the above document, and objected to an extent and reminded the manager that the so called "risky preferreds" had been quite lucrative to the firm and specifically stated: "let's not forget how much $$$ this business contributed to the firm in '04, '05. '06 and who got paid from it – SSG." (See Exhibit 47)

287. In the same email, Price referred to August 2007 as "when the carnage began" in Merrill Lynch's auction program. (Id.)

288. Likewise, Inventory concerns at Merrill Lynch continued. In one January 18, 2008 email Constable sent to GMI Sales, she stated:

> Mike and team: It's a double day and we have to also buy back many of the securities from the MLI account early this morning, not to mention we are about to get shellacked from terrified investors and we HAVE TO SELL INVENTORY! !"

(See Exhibit 48) (Emphasis in original)

289. On January 23, 2008, word began circulating among broker-dealers that Lehman Brothers had a number of auctions fail the previous day. In responding to a question from a Merrill Lynch investment banker regarding an issuer client who had concerns regarding the auction market, Brewer opined:

> Ian-
> Lehman failed 5 auctions yesterday – this is unprecedented. I am not sure what to tell [the issuer client] but, in my opinion, **we have to let [the client] know that we feel the auction market is going to get worse not better and they would be best served exiting the market.**

(See Exhibit 49) (Emphasis added)

290. Similar concerns were not shared with FAs or retail customers.

291. On the same day, Conery notified his boss, Mary Rooney of the Lehman auction failures. "...Fyi, new crisis brewing on the auction side. We've had 3 parties confirm that Lehman is dropping out of the auction business. Nothing like adding further illiquidity to an already illiquid market..." When asked to opine on the probable outlook for the market, Conery replied: "Challenged, but prob OK in the safer sectors. If-y in the lesser credit/structures." (See Exhibit 50)

292. Also, on January 23, 2007, Conery emailed Maier and stated, "It's really ugly out there. It could make you long for the calm days of this past August." (See Exhibit 51)

293. Meanwhile, Merrill Lynch's Research Department continued to issue research pieces that sought to accentuate the positives of the auction market while minimizing the negatives.

294. On January 28, 2008, Conery had been reviewing a research piece written by fellow Closed End Fund Research Analyst, Jon Maier. The piece dealt with the recent closed end fund auction failure from the previous week. Conery initially responded to Maier's request for Conery's suggested changes, to which Conery replied: "I'm working on it. **I was afraid some of our language would give the auction an unnecessary problem: a run**."
(See Exhibit 52) (Emphasis added)

295. Some thirty minutes later, Conery sent Maier the suggested changes with a note cautioning Maier to have the piece reviewed again before going out, to prevent being accused of "causing a run on the auction desk." (See Exhibit 40)

296. On January 28, 2008, after having been forwarded another negative story regarding a recent auction failure, Constable simply forwarded the piece to Price with the note, "[i]ts like the Sorcerer's Apprentice...cant someone make these people stop bucketing us with water..." (See Exhibit 53)

297. Between the dates February 1, 2008 and February 8, 2008, Conery wrote or contributed to approximately three published research pieces, including: Fixed Income Digest, "Preserve Income Lock in Yields"; Fixed Income Digest Supplement, "Auction Market Securities" and Auction Market Value Sheet, "Back to Basics In The Auction Market." In each of these publications, he continued to recommend that investors should feel confident about the auction market.

(See Composite Exhibit 3)

298. On or about February 1, 2008, Merrill Lynch's Research Department published a volume of its Fixed Income Digest, entitled "Preserve Income Lock in Yields," Conery and Mauro were listed as contributors to the piece. The cover page included a section entitled "Preserve Income." The last sentence of the section provided: "For funds that investors need to keep liquid, we continue to find the best value in auction market securities." Inside the research piece, there was a subheading: "For Cash Holdings: auction market securities," which recommended, [n]aturally, most investors need to keep some portion of their portfolios in liquid cash-like instruments. We find auction market securities (AMS) to be better alternative than money funds for these purposes for investors with larger amounts to invest." The section was followed immediately by another section dedicated to: "Answering Your Questions About Auction Market Securities" which responded to common questions relating to the auction markets at the time. (See Composite Exhibit 3)

299. On February 4, 2008, the Research Department re-published the "Answering Questions" piece on its own as a supplement to the Fixed Income Digest in part, because of questions the Research Department was getting calls and that FAs were likely having a problem locating the information in the otherwise lengthy February 1, 2008 publication. (See Composite Exhibit 3)

300. On February 7, 2008, some five days before Merrill Lynch decided to voluntarily withdraw from the auction market, Conery participated in a Closed End Fund monthly conference call with FAs to discuss recent market events. In discussing whether all closed-end funds auctions were suspect or likely to fail, Conery disagreed and told FAs, in part:

> One thing I would say is that it does highlight, and we said this on and off for the past several years, is that investor in the auction market should know their broker/dealer and should know whether or not their broker/dealer is committed to the product.
>
> I will tell you Merrill Lynch, certainly by all indications, is committed to this product. I would have to let the desk people speak for themselves, but given the fact that through all this turmoil they continue to plod away, I think that shows that the firm is committed to it.

301. After conceding that Merrill Lynch was not willing to guarantee continued commitment to the auction business, ("there are no guarantees in anything") Conery added,

> But is it an area we think represents a good, conservative, reasonable investment? Yes, it is. We are quite comfortable with buying Aaa one week closed-end paper. We are quite comfortable buying Aaa one month closed-end fund paper, whether its taxable or tax exempt we feel pretty good about it. But I will be the first to say that the rumors out there flying are pretty wild or pretty amazing. If you listen to them all it would probably drive you nuts, because I know it's driving me nuts, but you need to differentiate between what's rumor and what's fact.

302. During the same call, one FA asked a question that touched upon whether the recent auction failures had any consequences for Merrill Lynch, to which Conery answered: "[the Closed End Fund that experienced the prior auction failure] has so much outstanding in this sector, which is I think a testament to back up my point that I don't think this is any sort of contagion market-wide disaster scenario."

303. On February 8, 2008, Conery published his research piece entitled, "Back to Basics In The Auction Market." In it, Conery continued to find ARS "to be attractive" investments. Further, Conery noted:

> We continue to be impressed by the auction market's resiliency in the face of challenging times. We recommend that investors focus on what made the auction market great to begin with, conservative and understandable credits and traditional product structure.

(See Composite Exhibit 3)

304. On the evening of February 12, 2008, Merrill Lynch executives decided to cease supporting its auction rate securities program and intentionally allowed the vast majority of their auctions to fail the following day.

305. Constable testified that after it was learned that two other broker-dealers, with significant auction market businesses, broadly failed their auctions on February 12, 2008, it was a fait accompli that the entire auction market would fail.

306. Merrill Lynch's decision to stop broadly supporting its auction program was made without any real consideration or analysis of its effect on retail and other investors holding the securities.

H. Merrill Lynch Has Marked Down Its Own Inventory of Auction Rate Securities, But Still has Not Marked Down The Estimated Value Of The Auction Rate Securities On Its Clients' Account Statements.

307. Merrill Lynch has marked down the value of its own inventory of auction rate securities, yet has not marked down the value of those same auction rate securities in its client statements.

308. In her on-the-record interview with the Division, Constable testified as follows:

> Q. Ms. Constable, since February 13th, has Merrill Lynch marked down any of the auction rate securities that it holds in its own inventory?

> A. Yes. And what are those valuations or those markdowns? Do they have a spread?
>
> A. No. Not that I can -- they're all individually different.
>
> Q. Okay. Do you have an understanding of whether since February 13th that Merrill Lynch has marked down any of the auction rate securities on client statements?
>
> A. I don't believe so.

309. In his on-the-record interview with the Division, Price testified that from February 13 to the present, "[w]e have marked down securities, and obviously the firm marked down their CDO inventory as well, contingent capital inventory. And since February 13th we have marked closed end fund inventory, DRD inventory. Generally we have marked down all of our inventory."

310. When asked that the percentage of mark-downs was, he responded: "Approximately anywhere from zero to ten percent on some, and some as much as twenty, twenty percent."

311. When asked if the same markdowns have been made of the same securities that are held in client accounts, he testified: "I'm not sure."

312. According to client statements received form the Division, auction rate securities listed on client statements have not been marked down to reflect their illiquidity. Their "estimated market value" is still listed as 100 percent of par. Certain of the exact same instruments held by Merrill Lynch in its inventory have been marked down from par.

V.

CONCLUSIONS OF LAW

COUNT I – VIOLATIONS OF § 204 (a)(2)(G)

313. Section 204 (a)(2)(G) of the Act provides in pertinent part:

> (a) The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser:–
>
> (G) has engaged in any unethical or dishonest conduct or practices in the securities, commodities or insurance business.

314. The conduct of Merrill Lynch as alleged above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(G).

COUNT II – VIOLATIONS OF § 204 (a)(2)(J)

315. Section 204 (a)(2)(J) of the Act provides in pertinent part:

> The secretary may by order deny, suspend, or revoke any registration if he finds (1) that the order is in the public interest and (2) that the applicant or registrant (J) has failed reasonably to supervise agents, investment adviser representatives or other employees to assure compliance with this chapter.

316. The conduct of Merrill Lynch, as alleged above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(J).

VI.

ORDER

THEREFORE, it is hereby ORDERED, by Consent, as follows:

A. Relief for Auction Rate Securities Investors

1. Definitions and Buyback Offer

Merrill Lynch will provide liquidity to Eligible Investors by buying Eligible Auction Rate Securities that have failed at auction at least once between February 13, 2008 and the date of this Offer, at par, in the manner described below.

"Eligible Auction Rate Securities," for purposes of this Offer, shall mean auction rate securities publicly issued by municipalities or closed-end funds or backed by student loans and purchased at Merrill Lynch on or before February 13, 2008. Notwithstanding any other provision, Eligible Auction Rate Securities shall not include privately issued or placed auction rate securities that are unregistered and/or offered pursuant to SEC Rule 144A, or other exemptions of the Securities Act of 1933.

"Eligible Investors," for purposes of this Settlement, shall mean:

(i) Natural persons (including their IRA accounts, testamentary trust and estate accounts, custodian UGMA and UTMA accounts, and guardianship accounts) who purchased Eligible Auction Rate Securities at Merrill Lynch:

(ii) All small business and not for profit clients in Merrill Lynch's Global Wealth Management Group who purchased Eligible Auction Rate Securities at Merrill Lynch that had $100 million or less in assets in their accounts with Merrill Lynch, net of margin loans, as of August 7, 2008, or, if the customer was not a customer of Merrill Lynch as of August 7, 2008, as of the date that the customer terminated its customer relationship with Merrill Lynch. Notwithstanding any other provision, "small business and not for profit clients" does not include broker-dealers or banks acting as conduits for their customers.

2. <u>Tranche I Eligible Investors</u>

No later than September 26, 2008, Merrill Lynch shall have offered to purchase at par, plus any accrued but unpaid interest or dividends, Eligible Auction Rate Securities for which auctions are not successfully auctioning from Eligible Investors who had less than $4 million in assets at Merrill Lynch as of August 7, 2008. Merrill Lynch's offer to purchase such securities from Eligible Investors will remain open from October 1, 2008 through January 15, 2010, and Merrill Lynch shall promptly purchase such securities from any Eligible Investor who accepts this offer between January 2, 2009 and January 15, 2010.

For purposes of this Settlement, legal entities forming an investment vehicle for closely related individuals, including but not limited to IRA accounts, Trusts, Family Limited Partnerships and other legal entities performing a similar function, charities and non-profits, and small businesses who had less than $4 million in assets at Merrill Lynch shall be covered by Section VI.A.1.(i)

3. <u>Tranche II Eligible Investors</u>

No later than December 18, 2008, Merrill Lynch shall have offered to purchase at par, plus any accrued but unpaid interest or dividends, Eligible Auction Rate Securities from other Eligible Investors who purchased Eligible Auction Rate Securities from Merrill Lynch prior to February 13, 2008 and who had less than $100 million in assets at Merrill Lynch as of August 7, 2008.

Merrill Lynch's offer to purchase such securities from Eligible Investors shall remain open from January 2, 2009 through January 15, 2010, and Merrill Lynch shall promptly purchase such securities from any investor who accepts this offer between January 2, 2009 and January 15, 2010.

4. <u>Asset Amounts</u>

Merrill Lynch shall calculate investor asset amounts as of August 7, 2008 for all Eligible Investors with assets with Merrill Lynch as of that date. For Eligible Investors with no assets at Merrill Lynch as of that date, Merrill Lynch shall calculate investor asset amounts as of the date such investor removed their assets from Merrill Lynch.

5. <u>Notice and Assistance</u>

Merrill Lynch shall provide prompt notice to customers of the settlement terms, and Merrill Lynch shall establish a dedicated telephone assistance line, with appropriate staffing, to respond to questions from customers concerning the terms of the settlement.

6. Relief for Eligible Investors Who Sold Below Par

No later than October 1, 2008, any investor covered by Section VI.A , that Merrill Lynch can reasonably identify who sold Eligible Auction Rate Securities below par between February 13, 2008 and October 1, 2008 shall be paid by Merrill Lynch the difference between par and the price at which such investor sold the Eligible Auction Rate Securities.

7. Consequential Damages Claims

No later than October 1, 2008, Merrill Lynch shall make reasonable efforts promptly to notify those Eligible Investors covered by Section VI.A above who own Eligible Auction Rate Securities, pursuant to the terms of the settlement, that an independent arbitrator, under the auspices of the Financial Industry Regulatory Authority (FINRA), shall be available for the exclusive purpose of arbitrating any Eligible Investor's consequential-damages claim. Merrill Lynch shall consent to participate in the North American Securities Administrators Association's ("NASAA") Special Arbitration Procedures (the "SAP") established specifically for arbitrating any Eligible Investor's consequential damages claim arising from their inability to sell Eligible Auction Rate Securities. Nothing in this Offer shall serve to limit or expand any party's rights or obligations as provided under the SAP. Arbitration shall be conducted before a single non-industry arbitrator and Merrill Lynch will pay all forum and filing fees. Arbitrations asserting consequential damages of less than \$1 million will be decided through a single chair-qualified public arbitrator who will be appointed through the FINRA list selection process for single arbitrator cases. In arbitrations where the consequential damages claimed are greater than or equal to \$1 million, the parties can, by mutual agreement, expand the panel to include three public arbitrators who will be appointed through FINRA's list procedure.

Any Eligible Investors who choose to pursue such claims through the SAP shall bear the burden of proving that they suffered consequential damages and that such damages were caused by their inability to access funds invested in Eligible Auction Rate Securities at Merrill Lynch as of February 13, 2008. In the SAP, Merrill Lynch shall be able to defend itself against such claims; provided, however, that: Merrill Lunch shall not contest liability for the illiquidity of the underlying ARS position or use as part of its defense any decision by an Eligible Investor not to borrow money from Merrill Lynch. Special or punitive damages shall not be available in the SAP[2].

All customers, including but not limited to Eligible Investors who avail themselves of the relief provided pursuant to this Order, may pursue any remedies against Merrill Lynch available under the law. However, Eligible Investors that elect to utilize the SAP are limited to the remedies available in that process and may not bring or pursue a claim relating to Eligible Auction Rate Securities in another forum.

8. Institutional Investors Not Covered By Section VI. A

Merrill Lynch shall endeavor to continue to work with issuers and other interested parties, including regulatory and other authorities and industry participants, to expeditiously and on a best efforts basis provide liquidity solutions for institutional investors who purchased Eligible Auction Rate Securities from Merrill Lynch and are not entitled to participate in the buyback described in Section VI. A. above ("Institutional Investors").

Beginning January 2, 2009, and then quarterly after that, Merrill Lynch shall submit a written report to the State outlining the efforts in which Merrill Lynch has engaged and the results of those efforts with respect to Merrill Lynch Institutional Investors' holdings in Eligible Auction Rate Securities. Merrill Lynch shall confer with the Massachusetts Securities Division staff no less frequently than quarterly to discuss Merrill Lynch's progress to date. Such quarterly reports shall be submitted within 20 days

[2] However, it is agreed by the parties that "consequential damages" shall have a meaning separate and apart from "punitive or special damages." Under no circumstances should this provision be read to mean that a consequential damages claim may not be maintained due to any state law which may categorize consequential damages as a subset within punitive and/or special damages.

following the end of each quarter and continue until no later than January 15, 2010. Following every quarterly report, Massachusetts Securities Division shall have the option of requiring a meeting between the State and Merrill Lynch to advise Merrill Lynch of any concerns and, in response, Merrill Lynch shall detail the steps that Merrill Lynch plans to implement to address such concerns. The reporting or meeting deadlines set forth above may be amended with written permission from the Massachusetts Securities Division.

9. Relief for Municipal Issuers

Merrill Lynch shall refund refinancing fees to municipal auction rate issuers that issued such Eligible Auction Rate Securities in the initial primary market through Merrill Lynch between August 1, 2007 and February 13, 2008, and refinanced those securities through Merrill Lynch after February 13, 2008. Refinancing fees are those fees paid to Merrill Lynch in connecting with a refinancing and are exclusive of legal fees and any other fees or costs not paid to Merrill Lynch in connection with the transaction.

10. Penalties

Merrill Lynch shall pay fines and/or penalties totaling $125 million (the "Total Penalty") to the Commonwealth of Massachusetts and the other states which shall be allocated at the Commonwealth of Massachusetts and the other states' discretion, to resolve all underlying conduct relating to the sale of auction rate securities. Merrill Lynch shall pay $1,598,650.90 of the Total Penalty to the Commonwealth of Massachusetts. In the event another state securities regulator determines not to accept Respondents' settlement offer, the total amount of the payment to the Commonwealth shall not be affected, and shall remain at $1,598,650.90.

11. No Disqualification

The Order entered pursuant to this Offer hereby waives any disqualification contained in the laws of the Commonwealth of Massachusetts, or rules or regulations thereunder, including any disqualifications from relying upon the registration exemptions or safe harbor provisions that Merrill Lynch or any of its affiliates may be subject to. The Order entered pursuant to this Offer also is not intended to subject Merrill Lynch or any of its affiliates to any disqualifications contained in the federal securities laws, the rules and regulations thereunder, the rules and regulations of self regulatory organizations or various states' or U.S. Territories' securities laws, including, without limitation, any disqualifications from relying upon the registration exemptions or safe harbor provisions. In addition, this Order is not intended to form the basis for any such disqualifications.

Nothing herein shall preclude the Commonwealth of Massachusetts, its departments, agencies, boards, commissions, authorities, political subdivisions and corporations, other than the Massachusetts Securities Division and only to the extent set forth in herein, (collectively, "State Entities") and the officers, agents or employees of State Entities from asserting any claims, causes of action, or applications for compensatory, nominal and/or punitive damages, administrative, civil, criminal, or injunctive relief against Merrill Lynch, Pierce, Fenner & Smith Incorporated in connection with certain auction rate securities sales practices at Merrill Lynch, Pierce, Fenner & Smith Incorporated.

For any person or entity not a party to the Order issued pursuant to this Offer, this Offer and the Order do not limit or create any private rights or remedies against Merrill Lynch including, without limitation, the use of any e-mails or other documents of Merrill Lynch or of others for auction rate securities sales practices, limit or create liability of Merrill Lynch, or limit or create defenses of Merrill Lynch, to any claims

12. <u>In Consideration of the Settlement the State will:</u>

    a. Terminate the investigation by the Division and any other action that the Division could commence on behalf of the Commonwealth as it relates to Merrill Lynch's underwriting, marketing, and sales of ARS, provided, however, that excluded from and not covered by this paragraph are any claims by the Division arising from or relating to the "Order" provisions contained herein.

b. Terminate the administrative complaint with respect to Merrill Lynch (but not to individual respondents) in enforcement action docket no. E-08-0001, related to Merrill Lynch's sales of auction rate securities to municipalities. Such termination shall be subject to the entry of an appropriate Consent Order.

c. Refrain from taking legal action, if necessary, against Merrill Lynch with respect to its institutional investors until a date after December 31, 2009.

d. Not seek additional monetary penalties from Merrill Lynch relating to the issues raised by the State relating to Merrill Lynch's marketing and sale of auction rate securities to investors and the firm permitting trading in auction rates securities by any individuals affiliated with Merrill Lynch.

13. Failure to Comply With Terms of Settlement

If after this settlement is executed, Merrill Lynch fails to comply with any of the terms set forth herein, the State may institute an action to have this agreement declared null and void. Upon issuance of an appropriate order, after a fair hearing, a state may reinstitute the actions and investigations referenced in this Settlement Term Sheet.

WILLIAM FRANCIS GALVIN
SECRETARY OF THE COMMONWEALTH

By: ______________________________

Bryan J. Lantagne
Director
Massachusetts Securities Division
One Ashburton Place, 17th Floor
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Issued: April 13, 2009